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CHARLES ELMORE

IN THE

Supreme Court of the United States

October Term, 1948

No. 511

IN THE MATTER OF
THE PEORIA AND EASTERN RAILWAY COMPANY

INCOME BONDHOLDERS OF THE PEORIA AND EASTERN RAILWAY COMPANY,

Petitioners.

v.

THE NEW YORK CENTRAL RAILROAD COMPANY, THE CLEVELAND, CINCINNATI, CHICAGO AND ST. LOUIS RAILWAY COMPANY and THE PEORIA AND EASTERN RAILWAY COMPANY.

REPLY BRIEF OF THE PETITIONERS, INCOME BONDHOLDERS OF THE PEORIA AND EASTERN RAILWAY COMPANY

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1. Jurisdiction

The respondents, the New York Central and Big Four, argue that petitioners are not proper persons to apply for certiorari. Section 745 of the Bankruptcy Act, 53 Stat. 1141 (1939) (set out in the Petition, p. 72), allows the appli-

cation by "any person affected by the plan." These respondents argue that under §706, petitioners are not "affected by the plan."

Section 706 provides:

> "Sec. 706. No creditor shall be deemed to be 'affected' by any plan unless such plan proposes a modification of the evidence of debt or other instrument defining the rights of such creditor, or a modification of the security, if any, for the claim of such creditor."

While petitioners, as will be seen below, pages 3-4, meet this test set up by §706, that section does not apply where, as here, the petitioners are asserting not their own rights as "creditors" but, in a derivative capacity, the rights of the Debtor, the Peoria and Eastern.

The present dispute is wholly one between the Debtor, the Peoria and Eastern, and the Operating Companies (see petition, p. 36). It involves the fiduciary standards to be applied as between them, and the determination of the inter-company accounts in accordance with those standards. The plan of adjustment, as now amended by the District Court to allow most of the claims of the Operating Companies, substantially resolves the issues against the Peoria and Eastern as a whole.

If the Peoria and Eastern were not dominated by the Operating Companies, it could without question have filed a petition for certiorari in its own interest. There can also be no question under §745 but that minority stockholders could petition in a derivative capacity on behalf of the Peoria and Eastern. If, because of §706, which applies only to "creditors", the Income Bondholders, whose derivative interest for this purpose is precisely

identical with that of the stockholders,* could not petition for certiorari in behalf of the Peoria and Eastern, the result would be at least anomalous, and probably unconstitutional. It is apparent, therefore, that §706 was not intended to, and does not, apply in connection with §745 when a creditor acts only in a derivative capacity to assert rights of the Debtor.

Moreover, we have shown in the Petition, pp. 19-20, that in every practical sense the Income Bondholders, themselves, have a direct and vital interest in the plan of adjustment as *now* amended by the District Court, and that they are thus affected by it. (The contrary finding, referred to at p. 7 of the brief of the New York Central and Big Four, was made *before* the modifications of the plan now in question, and is therefore irrelevant here.)

The effect of the plan on petitioners comes within the language and meaning of §706. The "instrument defining the rights" of the petitioners is the Income Mortgage, which is by its terms subordinate in certain respects to the Operating Agreement (S. 185). The Plan makes determinations with respect to the fiduciary standards under the Operating Agreement and with respect to the alleged operating debt. These determinations clearly affect the "security" for the income bonds. See *Matter of Kinney*, 279 N. Y. 423, 431-432, 18 N. E. (2d) 645, 649 (1939); noted in 39 Columbia Law Rev. 1037 (1939). Indeed the plan as now amended by the District Court would not only impair the value of the Income Bonds, but for all practical

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* At an earlier stage of this proceeding, the District Court said that the "income bondholders occupy much the same position as preferred shareholders, and as such they have a very lively interest in the payment of the accumulated advances." *Ewen* v. *Peoria & E. Ry. Co.*, 34 F. Supp. 332, 338 (S. D. N. Y., 1940).

purposes would remove all restraints on the Operating Companies' "use" of the Peoria and Eastern.

2. The Inter-company Accounts.

The respondents, the New York Central and the Big Four, make two points as to the inter-company accounts, pp. 5-6, first, that they accurately set forth the "actual receipts and disbursements" of the Peoria and Eastern, and, second, that they were kept in conformity with Interstate Commerce Commission requirements.

As stated in the petition, pp. 10, 11, 15 and 22, the inter-company accounts set forth *only* what the Operating Companies, themselves, as a part of their self-dealing apportionment of joint revenues and expenses, had determined should be the "actual" receipts and disbursements of the Peoria and Eastern.

The Interstate Commerce Commission Uniform System of Accounts, as the name implies, is concerned with the method of setting up the books of a company, with a view towards promoting uniformity of railroad accounts. It has no bearing upon the self-dealing methods employed by the Operating Companies to determine the Peoria and Eastern's revenues and expenses. The comptroller of the Operating Companies so testified. See R. 20, pp. 2472-2473. Indeed the District Court held that the Commission lacked jurisdiction over these questions. See Petition, p. 41, and S. 31.

3. The Standard of Fiduciary Duty.

It will be noted that the respondents, the New York Central and the Big Four, make no attempt to justify, and indeed do not even mention, the indefensible fiduciary

standards laid down by the District Court, including the erroneous placing of the burden of proof on the beneficiary. Nor do these respondents suggest any other standard; they go no further than to argue that the usual fiduciary standards do not apply (Brief, pp. 8-13). They cite nothing in the Operating Agreement specifically warranting any relaxation of the rules as to a self-dealing fiduciary; there is only a quotation of the District Court's statement as to what the Agreement "presupposed".

These respondents appear to argue also (p. 11) that the rule of *Pepper* v. *Litton*, 308 U. S. 295 (1939), to the effect that the burden of proof is on the fiduciary to show fairness in his self-dealing transactions, applies only in cases of "spoliation, mismanagement and faithless stewardship." The fiduciary standards, of course, apply regardless of spoliation. *Southern Pacific Co.* v. *Bogert*, 250 U. S. 483, 492 (1919). If the fiduciary duties are not satisfied, the fiduciary's claim is disallowed or the fiduciary is surcharged. Similarly, respondents' quotation of the District Court's statement that they had acquitted themselves creditably in the inter-company transactions, is beside the point. This statement, of course, means only that the Operating Companies did not violate the District Court's standards, which, in their practical application, placed no restrictions upon them.

4. The Items of Account.

The respondents, the New York Central and the Big Four, erroneously assert that the petitioners in their discussion of the items of account, petition, pp. 40-55, are merely seeking to review facts concurrently found by the Special Master and the District Court (Brief, p. 15). This misses the entire point of this portion of the petition, the

purpose of which was to show that the result in each instance depended upon the erroneous fiduciary standards (which are standards of law) laid down by the District Court (see Petition, pp. 40-55).

5. The Brief of the Peoria and Eastern.

The position of counsel, selected for the Peoria and Eastern by its adversaries, the Operating Companies (see Petition, p. 14), is characteristic of what has happened at all stages of this litigation. As we pointed out in the petition, p. 14, he has throughout the case opposed all the major positions advocated by the Income Bondholders in behalf of the Peoria and Eastern. In this instance, while his brief is merely submitted "with respect to the petition," its tenor is one of opposition to review by this Court. The brief even goes beyond the District Court's holding of limited fiduciary duties, and the recognition by the Operating Companies of "modified" fiduciary duties (brief of N. Y. Central, pp. 9-10), to assert that the "relationship of the parties . . . does not involve any fiduciary duty . . ." (brief of P. & E., p. 16).

The fact is that here, as throughout this proceeding, the real interests of the Peoria and Eastern have been represented by the Income Bondholders (see pp. 2-3, *supra*), rather than by counsel for the Peoria and Eastern.*

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* Counsel also refers (p. 18) to the fact that the Peoria and Eastern "was deprived of interest" on its earnings for the years 1942-1944, held by the New York Central pending the disposition of this case (S. 77-78). It should be noted that counsel for the Peoria and Eastern, after stating to the District Court that he had recognized the question from the beginning of his participation in the case but took no action upon it, opposed the allowance of such interest to his client.

6. Conclusion.

This case, as shown in the petition, involves far more than the interpretation of the Operating Agreement or determination of issues of fact, as stated by the respondents, the New York Central and the Big Four, brief, p. 16. If the District Court was right, then the fiduciary standards laid down in this Court's opinions would be worthless as a protection against excesses of fiduciaries, in any case where the fiduciary takes the precaution of patterning its relationships with its beneficiary upon those presented here.

We submit that these questions are of such far-reaching importance as to deserve this Court's attention.

Respectfully submitted,

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